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SOME POLITICAL IMPLICATIONS OF PERSISTENT INFLATION IN WESTERN EUROPE

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NOTE

This paper addresses the question "What if rapid inflation continues in Western Europe?" It is not a systematic study of the causes of the economic difficulties Europe has been experiencing, nor does it attempt to forecast economic trends. The paper explores certain social and political implications which might come from a continuance of the economic malaise that Europe has been experiencing.

The purpose of the paper is to provoke thought and discussion about possible and plausible developments which would impinge on US interests and have serious consequences for them. Readers familiar with economic developments in Europe may prefer to begin with Section III on page 11.

The author consulted other offices of the Central Intelligence Agency in preparing this study. OPR acknowledges many helpful suggestions and criticism, but there was no attempt to seek formal coordination. Comments are welcomed by [redacted] Code 143, Ext. 5441.

It is possible, many would say likely, that Western Europe will emerge from the current period of high inflation and prolonged recession with the help of standard economic policies designed to temper the effects of the business cycle and without any major changes in the social and political fabric. But it is also possible that the economic malaise will prove to be intractable — that inflation will persist and even rise, resulting in stagflation of a particularly virulent sort. If this happens, substantial improvement would probably require profound change in social and political as well as in economic policies.

In some countries (especially the U.K.), organized labor and other powerful interest groups would be likely to resist paying the costs of such basic changes. Resistance would result not only in a worsening of economic problems but in a rise in political and social tensions as well. Over time, the inability of popularly-elected governments to promote economic well-being and to maintain domestic peace would raise serious challenges to existing institutions and practices — from either the left or the right, depending upon circumstances. The resolution of such challenges would vary from country to country. And those (such as Germany) with a high degree of social cohesion would be relatively immune at first. Nonetheless, and again over time, some countries would either suffer increased national debility or resort to authoritarian solutions with marked overtones of economic nationalism.

The purpose of this paper is not to predict either a gloomy economic future for Europe or dramatic political departures, but rather to assess the implications should such events indeed take place. Certainly a profound preoccupation with domestic turbulence and/or the advent of authoritarian and autarkic regimes would place European economic cooperation under severe strain. Interest in and support for mutual defense, including NATO, would probably greatly diminish. The current economic malaise has already produced some movement in this direction — protectionist measures re trade, investment, and foreign workers, and cutbacks in defense spending. Though the intensification and prolongation of the malaise might at some future point give rise to renewed emphasis on European unity (with or without a prominent US role), it seems more likely to develop momentum in the opposite direction.

If developments in Europe are of the "worst case" nature, the US would face a range of unfamiliar problems not only in relations with individual countries but also (and probably especially) with the region as a whole. Semi-Fascist or leftist revolutionary regimes in the major capitals of Western Europe would likely prove a nasty as well as unfamiliar experience. Efforts to gain support on what are now generally viewed as common interests -- in defense, in economic cooperation, and in relations with the Third World -- would be greatly complicated if not totally stymied. Such a change in Europe could have incalculable effects on international political relations, especially on US-Soviet detente.

SOME POLITICAL IMPLICATIONS OF PERSISTENT INFLATION IN WESTERN EUROPE

I. THE CURRENT MALAISE

There is widespread concern in practically all the nations of Western Europe about the political and social implications of the current economic problems. Some fear a recurrence of the Great Depression as unemployment continues to rise. Others see a Great Inflation just around the corner if efforts to promote recovery prove too strong. Still others fear a prolonged stagflation if renewed inflation prevents full recovery from the present recession.

Severe economic problems -- whether rapid inflation or prolonged recession -- do not necessarily lead to major social upheaval or radical political change. But history does suggest that such situations tend to weaken popular confidence in the existing political and social systems. Hence, many observers are concerned about the political and social repercussions of Western Europe's economic problems. For example, some fear the rise of militant leftist coalitions bent on protecting the workers from the full effect of recession; others worry about a major shift to the right, including the rise of authoritarian governments bent on correcting inflation and preserving order at almost any cost. The underlying concern is that the continued inability of democratic governments to facilitate relatively steady growth without massive inflation and/or deep recession would pose a serious challenge to democratic institutions, and lead to the erosion of free market economic policies.

In short, the concerns are widespread and sometimes mutually contradictory, but in one way or another they reflect a feeling that the political-economic situation of Western Europe has gone beyond the comfortable parameters of the past several decades. The foundations of governments, financial systems, industrial and intergovernmental relations are seen to be shaken. Confidence in a serene future seems extraordinarily low.

II. ONE INTERPRETATION OF THE ROOT OF THE MALAISE*

The Great Depression of the 1930s was something of a watershed in public perception of the role of government in economic affairs. Before then, in most European countries, government's role was largely confined to promoting political order and protecting national interests (including economic interests). Government's role in internal economic affairs usually was the relatively restricted one of raising revenue for its own purposes and mediating some of the conflicts between competing interest groups. But the length

*It is recognized that this analysis is oversimplified and omits a number of contributing factors, but this is done deliberately in the interest of brevity. It is further recognized that there are almost as many interpretations as there are students of the world scene, and that many will not agree in whole or in part with this one.

and severity of the Great Depression, combined with the enormity of the conflict which ended it, led most of the democratic and not-so-democratic governments of the post-war period to change their perceptions of the necessary economic role they should play. Almost everywhere in Europe and in other developed areas, "full employment" became a prime concern of post-war economic policy, because many feared another depression above all else.

Along with the popularly accepted need for governments to manage economic policy to ensure "full employment" came an expanding role for government in terms of promoting and ensuring social welfare — i.e., not only jobs, but health, housing, and the care of the poor, aged, or helpless. And in almost all the countries of Western Europe, such policies seemed to work better than most people had ever hoped. Real incomes rose markedly and fairly steadily for most groups; general welfare improved and unemployment stayed low. The swings of the business cycle were muted and in most countries social conflict, though not eliminated, also was assuaged by the fact that the economic pie grew fast enough so that practically every group benefited.

Since practically everyone came to anticipate and depend on further gains, European governments could not be elected or hold onto power unless they could promise continued substantial improvements in popular well-being. In the process, the governments' scope and share of total expenditures grew. So did the public's expectation that government could ameliorate social injustice or inequity if only it adopted the proper policy. Thus, in effect, the process of resource allocation became highly politicized.

There were, however, several other significant changes. Before the Depression, employment, output, and prices in a given country generally rose or fell together and at least one or more of the major economies were usually in the upswing part of the business cycle while one or more of the others were in the downswing. Hence, international trade and financial ties tended to mitigate the effects of the cycle. Since World War II, however, the general price level has rarely if ever fallen in any major country even in a recession (although it did rise more slowly in recession than in boom). And over the years the business cycles of many countries began to coincide.

The general prosperity enjoyed since the 1950s was accompanied by a marked increase in international economic interdependence on the part of practically every European country and much of the rest of the world. Formation of the EC both reflected and promoted this interdependence which further served to stimulate economic growth, and to create in effect a real "world economy" where events in any major country had an impact on the others.

By the early 1970s, many had come to fear it was virtually impossible for a developed country to enjoy low unemployment levels (as popularly defined), high levels of plant use and output, and relatively stable price levels. Many came to see an unavoidable connection between inflation and full employment. Efforts to damp inflation caused a rise in unemployment and few governments could keep such "stabilization" measures in effect long enough to end either inflation or the expectation of inflation. None could survive if it held on until it became the popular belief that the government itself was prolonging the ensuing recession and with it, politically unacceptable unemployment. Moreover, social welfare payments accounted for a growing share of government spending, even in times of shrinking revenues.

Thus the expectation of chronic inflation grew -- as did the acceptance of such inflation as a necessary concomitant to substantial improvements in consumption levels and general economic well being. In recent years, this popular anticipation, combined with the practically simultaneous upswing in the business cycle in much of the industrial world, helped to cause inflation rates to rise.

With the qualified exception of Germany, unemployment was still more feared than inflation, although rates of inflation were unprecedented in many European countries. And so long as inflation was considered the lesser of these evils in countries where powerful social groups had come to expect and act on the anticipated further inflation, the phenomenon fed on itself.*

Then came the "oil shocks" of 1973-1974 -- when in the space of months, the cost of oil quadrupled. This had both an inflationary and deflationary impact -- inflationary in terms of domestic costs and prices and deflationary in terms of economic activity and the balance of payments since it drained purchasing power out of an economy. That shock increased the need for profound change in most European economies, and indeed the whole industrial world was suddenly faced with high-cost energy. But structural change** is always difficult politically, because the burden falls unevenly on different social and economic groups. Now, with the added problem of recycling the oil-producers' surplus revenues, of the vastly greater degree of international interdependence, and of the suddenness of the shift in costs of energy, structural changes are likely to be even more difficult and divisive.

* "In modern cost - push inflation, prices and wages begin to creep upward even before employment is full and industrial capacity fully utilized. To clamp down on monetary and fiscal policy to fight such inflation will only result in unemployment and stagnation. But not to act is to accept creeping inflation that may accelerate into a canter or gallop." Paul A. Samuelson - Economics, 9th Ed., McGraw-Hill 1973, p. 837.

** For purposes of this paper, structural change means basic or fundamental change in political, economic, or social patterns of activity to adjust to or to overcome a major problem or bottleneck -- e.g., a shift away from high energy consumption per unit of output.

Moreover, in the past, necessary structural adjustments took place largely in the private sector and governments were not called upon to manage them directly and in detail. Now the role of government in the economy is considerably greater: not only is it expected to mitigate hardship and provide for social welfare, but in many cases governments also control policy towards natural resources and food. Moreover, the nascent confrontation between industrialized countries and the producers of many important raw materials is likely to make it much more difficult to expand the supply of such commodities or ensure orderly markets for them.

Thus, Western Europe as a major part of the industrial world is confronted with the need for structural change while experiencing high inflation rates and the deepest recession since the Great Depression. A number of observers fear that national efforts to end the recession will result in a Great Inflation by the late 1970s, which will, in turn, have enormous impact on European society and polity in terms of national entities and as a community.

The scenario for this fear goes something like this. The current recession was caused largely by the previous world-wide boom and its accompanying inflation which in turn caused severe bottlenecks in critical supplies, rising costs especially in wages, and reduced growth of real consumer income despite pay increases.

Governments also imposed restraining policies in varying degrees — i.e., fiscal and monetary measures designed to slow the boom. Since practically the whole world was booming at the same time, when the turnaround came, it too was widespread and severe. Now practically all the major countries are trying to reduce the resultant unemployment which, however each nation measu · it, has risen alarmingly nearly everywhere. Reflation, already begun in some countries, starts from still high rates of price inflation, and unless handled with great skill, it will cause even greater inflation throughout most if not all the industrial world by 1977 or 1978.*

Some fear the next round will be hyper-inflation — rates far higher than those which seemed so shocking in 1974. They argue that the economic policies which seemed so successful over the past two decades can no longer work because expectations have changed. Such policies have lost credibility; individuals and businesses act on the assumption that inflation is inevitable and thereby help make it so. Moreover, they argue, no popularly

* Simultaneous upturn means that most countries find their domestic boom reinforced by rising demand for their exports from others in the same position. This could quickly strain capacity enough to cause rapid inflation.

elected government in Western Europe can long survive if it deliberately imposes a cut in the real income of a politically powerful segment of the society.

Thus, for these pessimists, the future offers only rising inflation or stagflation as governments make ineffectual attempts to control inflation which result in the stop-go syndrome

25X6 [redacted] Prolonged stagnation of real income, in countries which have become thoroughly accustomed to rising consumption levels and improving social welfare, would pose a threat to democratic political institutions. The system would no longer be able to deliver on its promises — in frustration voters might turn to those who promised economic health but at the expense of democratic traditions, especially if real popular concern for and commitment to familiar institutions had waned.

III. IF THE PESSIMISTS ARE RIGHT?

How would rising inflation be likely to affect Western Europe if it should persist over a long period? Or if it should turn into a stop-go syndrome that resulted in prolonged stagnation of output combined with persistent inflation? Such questions seem worth exploring even though this paper does not predict the answers with any certainty.

Traditionally, inflation has had considerable social, economic, and political impact on individual countries. Not all of it bad, however. The industrial world has experienced inflation at greater or lesser rates for most of its history. (The pound sterling was once worth exactly that.) Socially, the helpless -- those who cannot increase their money income for either personal or political reasons -- are the worst hurt. They will usually include the aged or others living on fixed incomes, the very poor, and those employed in declining sectors of the economy. Economically, holders of assets fixed in money terms suffer much from persistent inflation because the purchasing power of their money earnings declines. Small businesses and middle-income groups are likely to be badly affected. Where taxes are progressive and efficiently collected, the real tax bite rises as money incomes rise. Both business and consumers suffer a decline in real buying power or profits. But not everyone or every sector of the economy is equally affected and some will gain: e.g., those who correctly anticipate inflation, those who are in the gaining sectors of the economy, those who speculate successfully.

In short, rapid inflation produces both social and economic inequities and imbalances as the lucky or clever gain and others lose. It also tends to produce the seeds of recession as business options become less and less constructive while investment capital flows towards speculative opportunities not all of which will be productive.

The worst case is when faith in money begins to be lost. Unless checked, anticipation of rising money costs becomes self-fulfilling: no one is willing to save or hold money or debt. This change is psychological as well as economic. With it comes total distrust of money (and of the issuing government) and demand for quick change. People replace government money with something else — cigarettes, potatoes, paintings, etc. — and there is a large re-distribution of real wealth. Faith in government and other social institutions is lessened or, in some cases, totally lost.

It may be, however, that the industrialized countries are learning to adjust to high inflation rates. Ten years ago, few in Western Europe would have thought 1974 inflation rates would have been possible in peacetime without major social and political upheavals. British and Italian rates -- 20 percent or more — would have seemed intolerable. Yet, Western Europe has coped with the economic malaise of the past few years without major social or political upheaval. But no one can be sure that chronic high rates of inflation can continue to be accommodated if they persist.

The most critical factors appear also to be the most elusive — that is, individuals' attitudes and perceptions. These psycho-cultural factors include social cohesion and faith in institutions, especially in the ability of government to manage. On this hypothesis, the outlook for the major West European countries if they experience continued high rates of inflation or stagflation differs considerably: the most endangered would be those which have the deepest social cleavages and antagonisms <u>and</u> in which the most is expected of government.*

If, as postulated, social cohesion is critical for political stability in a democratic country confronted with prolonged inflation or stagnation, then the United Kingdom would seem to be running grave risks. Its economic performance has been poor to dreadful for years — very slow growth, low levels of investment, and high rates of inflation. Its economy is in great need of structural change which can only be obtained through high levels of investment in competitive sectors -- yet much of the investable funds are spent by government in shoring up obsolescent firms to preserve the jobs they provide, e.g., in steel and automobiles.

Not only has organized labor been aggressive and powerful in pushing its case for higher wages (wage rates have risen by about one-third in the past year), but it has stressed redistribution of income and been almost totally uninterested in raising output. In effect, the focus has been on the status of class or group, with little or no concern for the society as a whole. Long-standing class divisions and antagonisms run deep,

* It is not the purpose of this paper to assess prospects in individual European countries but only to suggest what the critical factors in a few may be.

though this is often denied or discounted.* There is little or no national consensus on what needs to be done, yet widespread concern about what continued inflation (now over 20 percent a year), low productivity, and rising government spending may bring.

Paradoxically, the more ineffective government becomes (in terms of achieving even economic stability let alone growth) the more seems to be demanded of it (in terms of jobs, welfare, and social equity) and the less confidence is placed on it. Public apathy concerning parties, elections, and leadership seems to have deepened over the past few years. [redacted]

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Speculation about the consequences of prolonged inflation or stagflation elsewhere in Europe is even more difficult. Major social strains persist, although they have largely been held in check by the rising prosperity of recent decades.

The still numerous French peasantry and petite bourgeoisie have not enjoyed a full share of the economic gains since the war, and large numbers of skilled and unskilled workers still see themselves engaged in a class struggle with major employers. Moreover, farmers and small shopkeepers have been badly hurt by the current inflation. Prolonged stagflation would deeply affect the whole middle class. Nevertheless, the French economy is in far better shape, and the French government far more effective, than is the case for the U.K. or Italy.

Should high inflation or prolonged stagflation occur, however, then the frustration of popular expectations for full employment, improved living standards and gradual amelioration of social stresses raises the chances for another outbreak of mass violence and disaffection like those of 1958 and 1968. Discontent among the military would probably add a further disconcerting element. In such a situation, France might be strongly tempted to seek a charismatic strongman (another deGaulle?) who could cope.

For all its pressing economic and political problems, Italy at least has the advantage of great cynicism about its government. Italians have achieved considerable economic growth and social modernization in the past two decades in spite of governmental ineptitude, rather than because of any central direction by a succession of governments.

The Italian economy is, however, in deep trouble. The rise in oil prices hit it very hard, output has dropped, unemployment is rising rapidly. Inflation has been severe. Labor has recently insisted on and obtained sizeable cost of living and other payments which will strain industry's and the government's ability to cover. Thus, the outlook is for both continued high inflation and unemployment for a considerable period. And, if the rest of Europe is slow to climb out of the recession, as seems likely, returning migrant workers will continue to add to the unemployment problem.

Such returning migrants would add to the persistent social strains in the more prosperous northern areas of Italy. There, the millions of southerners who have moved to the cities have never really been integrated into the northern society. Worsening economic troubles would seriously hurt such groups and be translated into political malaise.

Italy may be on the verge of a general political crisis of a graver order than the many governmental crises of the past. Massive Communist gains in the last elections threaten the political arrangements that have existed since 1948. Unless Communist concerns are at least partially accommodated, Italy may become totally ungovernable. Prolonged inflation or stagflation would greatly complicate any attempts to sort out the new political alignments and develop workable governing mechanisms.

The more southern European countries — Spain, Portugal, Greece, and Turkey — will probably experience worse economic troubles than the more industrialized north if high rates of inflation persist. Their economies are already weaker and they will have the additional burden of reduced remittances from migrant workers and the return of some of these redundant workers from the north.

But they have long faced severe political and social problems. Prolonged inflation and economic malaise, while heightening other difficulties, would be less likely to cause new problems for these societies than it would in the more stable and prosperous north of Europe.

In sum, it is impossible to predict how individual countries would weather prolonged inflation or stagflation. Too much depends on unknowable social and political interactions and circumstances. Suffice it to say that such economic malaise would worsen whatever social strains existed and, at least in some cases, increase the chances of drastic political change as well.

IV. WHAT OF EUROPE AS AN ENTITY?

Assuming prolonged inflation or stagflation that led to serious domestic political and social problems, most (perhaps almost all) of the European countries would probably turn inward to concentrate on internal problems. Whether or not individual countries moved left or right, there would be strong pressures undermining European unity, and probably a rapid decline in willingness to spend money on mutual defense. Each would be tempted to resort to nationalistic attitudes of _sauve qui peut_ including import controls, competitive devaluations, etc. There have been a few signs of such protectionist attitudes already -- Italy imposed a form of import control in 1974, the U.K. has considered fairly stiff measures to help protect its balance of payments. Several countries have strongly discouraged migrant workers as unemployment rose, and one or two have cut their military budgets. In the face of economic nationalism, political loyalty to the concept of Europe as a community would be very hard to maintain. Support for NATO could be an early casualty.

In some countries, a decline in national cohesion would reinforce ethnic or regional or class demands, e.g., Scottish and Welsh separatism, unrest in Brittany. The whole political focus could shift away from the nation-state which some in these societies see as designed more for developing empires than for promoting socio-economic equity. The process may already have begun: the present strength of Scottish separatism would have seemed an unbelievable joke to most observers of the U.K. as recently as five years ago. In the face of prolonged popular frustration and/or stagnant living standards such movements could get stronger as faith in central governments diminished and smaller entities seemed to promise more political and cultural, if not economic, rewards.

Perhaps the worst case, from the point of view of European cooperation, would be a breakdown of social and economic order. For example, organized labor digs in and refuses to accept reductions in real purchasing power. Mass strikes and mutual labor support across national boundaries produce severe disruption of essential services. The resulting chaos could then lead to the suspension of parliamentary rule in favor of temporary rule by a charismatic strongman, calling out the troops to restore essential services etc. The new technocrats or managers might be attracted to some form of authoritarian rule in which private consumption and social welfare would be considered important but subordinate to stability and order. The same sort of technocratic fascism could result from a bad case of hyper-inflation leading to economic chaos. Under such circumstances, pressures for economic and even political autarky would be high. In any case, national problems would eclipse interest in regional cooperation and mutual defense.

The most favorable possible course for a Western Europe faced with severe and prolonged economic stress would be a prompt appreciation of the common danger that engendered cooperative efforts — led by the US because of its size and Germany because of its relative economic health. It is possible that the 1974-75 inflation and recession will mark another turning point in the way people and governments view inflation and consumerism — just as the Great Depression marked a shift in the attitudes towards unemployment. Control of inflation may come to be the primary goal of government economic policy (supplanting that of full employment). At the same time, emphasis on economic growth and constantly rising real incomes might be at least partially replaced by concern for equity and stability. Such shifts in public attitudes might then ease the difficult process of adjusting to global economic realities — helping to slow inflation and cope with food and raw material scarcities by reducing demand. Such basic changes in social and economic attitudes, however, are unlikely to come about without a period of severe stress.

What happens to Europe over the next 5-10 years will, of course, depend heavily on what happens in the rest of the world economy. If the US and Japan recover from their recessions without reverting to rapid inflation, for example, it will be much easier for Europe to follow suit. If the Third World demands for a new economic order more to its liking remain largely unmet, then the structural economic changes needed in Europe will be smaller and less difficult for its governments to achieve.

By the same token, what Europe did in response to persistent inflation would affect the rest of the world. European countries might try to strengthen their unity in the face of severe economic problems. There is some talk of a Euro-Mediterranean region that would include a number of OPEC oil producers and might become relatively independent of the rest of the world. Europe would employ the oil-producers' surplus revenues to make the investments necessary for structural change, and then repay its debts with the additional product such investment engendered by helping the LDCs in the group to industrialize and modernize their economies. If successful, a relatively closed economic region like this would tend to push the US and Japan to form similar regional groupings -- say North and South America in the first case, and Greater Asia in the second. The breakdown of the current interdependent world economy into such regional economies would have enormous impact on existing financial and trade problems, with a generally detrimental effect on economic well being, as well as on international political relations. While such a scenario seems unlikely, it is at least thinkable.

V. SOME IMPLICATIONS FOR THE US

This paper does not predict either a gloomy or a sanguine future for Western Europe. Nonetheless, there are troubling possibilities for the region with potentially serious implications for US interests. A prolongation of rapid inflation or stagflation in a given country would probably seriously challenge political and social cohesion and make it even more difficult to deal with the economic problem. The resultant weakening of the political and social fabric could lead either to national debility or to relatively authoritarian attempts to cope. In either case, the affected countries would probably turn inward, at considerable cost to European cooperation, to the functioning of NATO, and to the well being of the industrial nations as a group.

If developments in Europe are of a worst case nature, the familiar arrangements to which the US has become accustomed will disappear. This would be highly troublesome for US policy-makers used to decades of stability and inherent predictability in so much of Europe. [redacted] 25X6

25X6 Analogous questions or problems could be anticipated for other major countries.

Under such circumstances, the US would have to deal with a whole new Europe. The proliferation of deeply troubled, highly nationalistic, or provincially centered governments would not only be individually different and difficult for the US to deal with, but intensified economic and political competition among states would cause additional problems. US efforts to gain cooperation on what are now joint interests — in economic coordination and general international issues like relations with the Third World and nuclear proliferation — would be greatly complicated. Moreover, the whole basis and rationale for NATO could be eroded, with incalculable effects on US-Soviet detente and on East-West relations within Europe.